CONGRESSIONAL TESTIMONY

Costly, Concerning and Counterproductive:
The Federal Government's Compensation Premium and How to Capitalize On the Private Sector's Platform

Testimony before
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My name is Rachel Greszler. I am a Research Fellow in Economics, Budgets and Entitlements at The Heritage Foundation. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

The Congressional Budget Office (CBO) finds that the federal government provides significantly higher total compensation to its employees than private-sector employers provide. This is a problem for taxpayers who are over-taxed and over-indebted to over-pay federal workers. It is also a problem for the government. Although a compensation premium should serve to enhance the federal government's workforce and productivity, the federal government's faulty compensation and career advancement structures impede—instead of advance—government efficiency and achievement.

I would like to focus my testimony on three things. First, is the effect of federal benefits that are not included in the CBO's study on the federal compensation premium. Second, is the baseless and obstructive federal employment platform, and third is a set of recommendations that would help bring public-sector compensation in line with that of the private sector, helping make government more efficient and productive.

Broad Evidence of Significant Federal Compensation Premium

Overall, the CBO report finds a 17 percent compensation premium, consisting of a 3 percent wage premium and a 47 percent benefit premium.[1] Many other studies have also found significant federal compensation premiums. Back in 1980, Alan Krueger (who served as Chairman of President Obama's

[1]Congressional Budget Office, "Comparing the Compensation of Federal and Private-Sector Employees, 2011 to 2015," April 2017, https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/52637-federalprivatepay.pdf (accessed May 10, 2017).

Council of Economic Advisers) documented a federal pay premium.[2] More recently, a 2011 Heritage Foundation study found a slightly higher overall compensation premium between 30 percent and 40 percent[3] and a similar 2011 study by the American Enterprise Institute found a 61 percent premium.[4] The fact that federal employees quit their jobs at only one-fifth the rate of private-sector workers supports the nearly universal findings of a significant federal compensation premium.[5]

1. Omitted Compensation Costs and Benefits

Although the CBO's report examined both cash wages and major benefits, it did not include some forms of compensation that are difficult to value, unequally distributed, or that lack sufficient data. Including these additional benefits would further widen the gap between public and private compensation.
Among the benefits excluded by the CBO (and many other comparisons) are:

Student Loan Repayment. The federal government provides eligible employees with up to $10,000 a year and $60,000 total in student loan repayments. In 2015, federal agencies provided more than $69.5 million in repayments to 9,610 federal employees—an average annual benefit of over $7,200 per employee.[6] Student loan repayments were non-existent among private-sector benefits until recently. Although student loan repayments benefits are on the rise, only 4 percent of private-sector employers offer them and even the most generous private-sector plans provide only 10 percent to 20 percent as much in annual and maximum repayments as the federal government.[7]

Student Loan Forgiveness. Beginning in 2007, federal employees (as well as public-sector or nonprofit workers) became eligible for student loan forgiveness. Federal employees can have their student loan payments limited to as little as 10 percent of their income, and after 10 years (120 months) of on-time student loan payments, their remaining debt can be forgiven.[8] "Forgiven" is another way to say forked over to taxpayers.

[2]Alan B. Krueger, "Are Public Sector Workers Paid More than Their Alternative Wage? Evidence from Longitudinal Data and Job Queues," in Richard B. Freeman and Casey Ichniowski, eds., *When Public Sector Workers Unionize* (Cambridge, MA: National Bureau of Economic Research, 1988), http://www.nber.org/chapters/c7910.pdf (accessed June 9, 2016).

[3]James Sherk, "Inflated Federal Pay: How Americans Are Overtaxed to Overpay the Civil Service," Heritage Foundation *Center for Data Analysis Report* No. 10-05, July 7, 2010, http://www.heritage.org/research/reports/2010/07/inflated-federal-pay-how-americans-are-overtaxed-to-overpay-the-civil-service.

[4]Andrew G. Biggs and Jason Richwine, "Comparing Federal and Private Sector Compensation," American Enterprise Institute *Working Paper* No. 2011-02, June 1, 2011, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1991405 (accessed June 9, 2016).

[5]Bureau of Labor Statistics, Economic News Release, Table 4. Quits Levels and Rates by Industry and Region, Seasonally Adjusted, March 2017, (private = 2.4, federal = 0.5), https://www.bls.gov/news.release/jolts.t04.htm (accessed May 9, 2017).

[6]Office of Personnel Management, "Federal Student Loan Repayment Program, Calendar Year 2015," October 2016, https://www.opm.gov/policy-data-oversight/pay-leave/student-loan-repayment/reports/2015.pdf (accessed May 9, 2017).

[7]Among the top firms providing student loan repayments, most cap benefits at $1,200 to $2,000 per year and some cap total benefits at about $10,000. Zack Friedman, "Student Loan Repayment: The Hottest Employee Benefit of 2017," *Forbes*, December 19, 2016, https://www.forbes.com/sites/zackfriedman/2016/12/19/student-loan-repayment-benefit/#3d69b0191d6f (accessed May 9, 2017).

[8]Federal Student Aid, "The Public Service Loan Forgiveness Program," U.S. Department of Education, https://studentaid.ed.gov/sa/repay-loans/forgiveness-cancellation/public-service (accessed May 11, 2017).

A federal employee with $120,000 in student loans and a 30-year repayment period would have almost $95,000 in principle remaining on their student loan after 10 years. That is about twice the median earnings in the U.S., but for federal workers, it is just a job perk—and a misguided one at that.

After 10 years of employment, most workers have advanced in their careers and established sustainable living circumstances and finances. Yes, wiping out tens of thousands of dollars of debt and thousands of dollars in annual payments for select employees who clock 10 years of federal service is a huge benefit, but employees do not fully value it because they do not know if they will receive it. Moreover, a massive lump sum benefit 10 years into federal employment is less helpful than student loan relief early on in workers' careers when they have lower earnings. Consequently, student loan repayments function more as windfall benefits than to make government employment more competitive.

The federal government extends student loan forgiveness to workers in state and local governments as well as those in "public service" non-profit institutions. This allows those subsidized sectors to provide lower compensation than they would need to absent the student loan forgiveness and it presumes that certain groups of workers are more valuable to society than others. Private institutions can be just as valuable to society as government and non-profit institutions, yet this selective subsidy disadvantages private sector because companies are not privy to the federal government's ability to convey whatever costs or debts it chooses onto taxpayers.

Transportation Benefits. Federal employees are typically eligible for either free parking—something that can cost hundreds of dollars in cities such as DC—or tax-free mass transit benefits of up to $255 per month ($3,060 per year). Most private employers allow employees to claim transit subsidies, but employees typically pay their transit costs.

Retiree Health Benefits. Federal employees who have five or more years of federal service and who go directly from federal service to retirement are eligible (at a minimum age of 57) to receive the same health insurance subsidy during retirement that they received while working.[9] A 2002 study by the Congressional Budget Office (CBO) estimated the accrual cost of this benefit at $3,475 per year, or 6.4 percent of workers' pay.[10] Federal employees also enjoy a number of benefits that are more difficult to value or measure:

Childcare. Federal employees have greater access to on-site childcare. While most employees still pay for childcare, they pay less than they would absent the rent subsidy typically provided to on-site childcare providers.

Additionally, some federal employees who make less than about $70,000 a year can receive significant childcare payments from the federal government.[11] For example,

[9]Office of Personnel Management, "Continuing FEHB Coverage into Retirement," FAQ, https://www.opm.gov/faqs/topic/insure/?cid=880bfba8-8f8b-4e64-9a72-fae98408fd0e (accessed May 10, 2017).

[10]Authors' calculations establish the 6.34 percent of pay cost by comparing the average salary of $54,656 in 2002 to the estimated $3,475 accrual cost of FEHB benefits as reported in Congressional Budget Office, "The President's Proposal to Accrue Retirement Costs For Federal Employees," June 2002, https://www.cbo.gov/sites/default/files/107th-congress-2001-2002/reports/accrual.pdf (accessed May 16, 2016).

[11]Childcare subsidies are available to federal workers at select agencies and departments, and who make less than a certain amount per year. The maximum earnings amount below which workers qualify for childcare subsidies ranges from about $50,000 and $70,000 per year, depending on the agency and program. Financial

General Services Administration (GSA) employees receive federal subsidies to cover the portion of their childcare costs that exceed a specified percentage (ranging from 5 percent to 15 percent) of their Adjusted Gross Income (AGI). These subsidies can amount to tens of thousands of dollars per year, with an annual cap of just under $35,000.[12]

Preferable Work Schedules. Most workers recognize federal government jobs as requiring fewer total hours than similar private-sector positions, and as offering greater flexibility in schedules. For example, many federal employees work slightly longer days in exchange for every other Friday off. Better hours and flexibility are among the reasons many workers who want a better work-life balance seek out federal government jobs.

Job Security. Federal employees receive an invaluable benefit through superior job security. Federal law makes it extremely difficult to fire federal employees for poor performance, misconduct, or even posing a threat to the security of the agency. On average, it takes about a year and a half to fire a federal employee as they have access to multiple layers of appeals.[13] Consequently, the layoff and discharge rate for federal employees is only one-third that of the private sector.

2. Bad Business Structures Hurt Government Productivity and Unnecessarily Drive Up Taxpayer Costs

While the federal government's compensation premium should increase its competitiveness in attracting and retaining the best and brightest workers, the structure of the premium along with perverse features of the government's employment model instead weaken the government's competitiveness and efficiency. The government could optimize its workforce and save taxpayers tens of billions of dollars per year by shifting its compensation structure towards that of the private sector.

Unequal Compensation Premiums. As the CBO report showed, the federal compensation premium is not uniform across the federal workforce. According to the CBO study, the federal government overcompensates workers with no more than a high school education by 53 percent, compared to 21 percent for workers with a bachelor's degree.[14] For workers with professional or masters degrees, the CBO report shows the federal government actually undercompensates them by 18 percent. (These figures do not take into account the omitted benefits discussed above.)[15]

This structure directly contradicts the federal government's workforce needs. Compared to the private sector, the federal government has 2.5 times as many workers with master's degrees or higher and only about one-third as many workers with less than a high school degree.[16] Yet, the government provides the biggest compensation premium where it faces

Shared Services, "Child Care Subsidies for Federal Employees," U.S. Department of Agriculture, https://nfc.usda.gov/FSS/clientservices/Child_Care_Subsidy/ (accessed May 11, 2017).

[12]Financial Shared Services, "General Services Administration (GSA) Child Care Subsidy: Program Eligibility Determination and Financial Consideration," U.S. Department of Agriculture, https://nfc.usda.gov/FSS/clientservices/Child_Care_Subsidy/subsidies/GSA/eligibility.php#etable (accessed May 10, 2017).

[13]James Sherk, "IRS Abuses: Ensuring that Targeting Never Happens Again," testimony before the Oversight and Government Reform Committee, U.S. House of Representatives, August 6, 2014.

[14]Congressional Budget Office, "Comparing the Compensation of Federal and Private-Sector Employees, 2011 to 2015."

[15]Ibid.

[16]According to the April 2017 CBO report, 29 percent of the federal workforce had master's, doctoral, or professional degrees, compared to 11 percent of

the least competition for lower-educated workers and the smallest premium—even a penalty in some instances—where it faces the most competition among highly educated workers.

A productivity- and profit-maximizing private company that needs more skilled workers than its competitors provides equal or even greater compensation to attract and retain the best workers it can. Similarly, a private company that needs fewer lower-skilled workers than its competitors will not massively and unnecessarily overcompensate them.

Overweighting an Undervalued Benefit. Delayed compensation is less valuable to workers than immediate compensation and yet, the federal government provides at least three times as much delayed compensation—in the form of retirement benefits—as the private sector. Federal employees receive between 16.1 percent and 18.2 percent of their pay in retirement benefits, compared to about 3 percent to 5 percent for private workers.[17] While saving for retirement is a good thing, there is no one-size-fits-all prescription for the level and timing of retirement savings. Workers benefit from the freedom to choose when and how much to save. Some workers can afford to sack away significant retirement savings right from the get-go, and that is great for them. Others, however, who start with lower earnings or who begin a family and want to purchase a home or have to pay for childcare are better off with larger paychecks than retirement benefits.

With rising student loan debt, many recent college graduates are hard-pressed to meet their living expenses and student loan payments. The government's benefit-heavy and pay-light compensation almost certainly prevents many talented younger workers from taking jobs with the government.

Moreover, the government's primary retirement compensation is a defined benefit pension called the Federal Employees Retirement System, or FERS. Defined benefit pensions are largely undervalued, however, because employees do not know how much—if anything—they will eventually receive in pension benefits. It is not until workers attain significant tenure or near their retirement that they have a meaningful understanding of their pensions' value.

A study by Maria Fitzpatrick of Cornell University examined the value of defined benefit pensions to workers and concluded that defined benefit pensions are substantially inefficient forms of compensation with little value in attracting employees.[18] According to her analysis, Illinois' public teachers valued additional pension benefits at only 19 cents on the dollar.[19] It makes no sense for the federal government to provide a benefit that workers perceive as being worth only a fraction of its actual cost.

Shifting away from defined benefit compensation would be a win-win for federal employees and taxpayers. It provides the opportunity for federal employees to receive equally or even more valuable compensation at significantly lower costs.

Failure to Reward High Performers or Penalize Low Performers

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private-sector workers, and 13 percent of federal workers had a high school diploma or less compared to 36 percent of private-sector workers.

[17]Employees hired before 2013 receive a 13.2 percent contribution to FERS, those hired in 2013 or later receive an 11.1 percent FERS contribution. Additionally, all employees receive an automatic 1.0 percent contribution to their Thrift Savings Plan (TSP) and up to an additional 4 percent (5 percent total) in matching contributions.

[18]Maria D. Fitzpatrick, "How Much Do Public School Teachers Value Their Retirement Benefits?" Cornell University, https://www.human.cornell.edu/pam/people/upload/Fitzpatrick-Pensions-120117.pdf (accessed May 9, 2017).

[19]Ibid.

In the private sector, productivity determines workers' pay. If private employers pay employees more than they produce, they lose business to competitors who do not over-pay their employees. Similarly, if private employers pay workers less than their productivity warrants, they lose those workers to competitors who will pay them more.

That is not the case in the federal government. The federal government has a monopoly over federal services and federal tax collections, as well as a seemingly limitless line of credit with current and future taxpayers. That translates into the federal government having little incentive to minimize costs or maximize efficiency.

Automatic Pay Increases. In theory, the federal government's pay scale is supposed to approximate private-sector, market-driven wages. In practice, however, many government wages bear little resemblance to similar private-sector wages.

The 2011 Heritage study found that much of the unexplained wage premium in the federal government comes from more rapid raises and promotions particularly in the lower-level steps when increases are more frequent.[20] This helps explain why the federal pay premium is generally highest for lower-earning workers and lowest for higher-earning workers.

Instead of performance-based pay increases, federal workers receive two effectively automatic pay increases. First, is an annual cost-of-living increase—something that rarely exists in the private sector—and second, is an allegedly performance-based pay increase every one, two, or three years for employees in the lower steps (and less frequent increases for employees in higher steps).

The bar is very low, however, for receiving "performance"-based increases—all that is necessary is a rating of at least three out of five—and employees who receive lower ratings have access to and actively utilize multiple procedural tools to contest their low ratings. Consequently, virtually all federal employees—more than 99.9 percent—receive "performance-based" pay increases.

Failure to Reward High Performers. In the private sector (aside from union-negotiated compensation packages), performance drives pay. That is not so in the federal government. Although managers can award performance-based bonuses (on top of the two aforementioned raises), these bonuses are limited both in availability and use. The 2011 Heritage analysis found that less than one-quarter of federal pay increases are meaningfully tied to performance.[21]

Failure to Penalize Poor Performers. While the federal government does little to incentivize workers to perform their best or to reward those who go beyond their call of duty, it also does almost nothing to penalize poor performers. In some ways, it actually incentivizes poor performers by shifting part of their work to higher-performing workers.

Federal managers are supposed to be able to establish performance improvement plans for low-performing workers, but it is so difficult and time consuming to do so that most federal managers consider it a waste of their time. According to a study by the Office of Personnel Management (OPM), almost 80 percent of all federal managers have managed a poorly performing employee, but fewer than 15 percent issued less than fully successful ratings for problematic employees and fewer than 8 percent attempted to reassign, demote, or remove problematic employees.[22] Among

[20] Sherk, "Inflated Federal Pay."
[21] Ibid.
[22] Office of Merit Systems Oversight and Effectiveness, "Poor Performers in Government: A Quest for the True

those who attempted action against problematic employees, fully 78 percent said their efforts had no effect.[23] That means that in a pool of 50 poorly performing federal employees, only one will experience any significant consequences.

It is no wonder that the federal government's annual 0.4 percent firing rate is only one-third that of the private sector.[24] The federal government's failure to encourage and reward high performance along with its failure to discipline poor performers is a recipe for driving out the most productive employees and retaining the least productive ones. That is the exact opposite of what business schools teach and what successful private businesses practice.

3. How to Bring Federal Compensation in Line with the Private Sector

The impetus for bringing federal compensation in line with that of the private sector is not just to cut costs; it is also about improving the effectiveness and accountability of the federal government and turning unproductive resources and practices into productive ones. The government can accomplish this by piggybacking on the way private employers respond to market forces.

Hiring and Firing Procedures. The current federal employment system shelters bad employees by forcing managers to navigate an excessively burdensome process that takes a year and a half, on average, to fire a federal employee.[25] Consequently, the federal government terminated only 0.3 percent of its tenured workforce for performance or misconduct in 2013.[26] This results in higher-than-necessary employment as agencies must hire additional employees to get the job done.

Congress should make dismissing federal employees less difficult by: extending the probationary period from one year to three years; requiring employees to appeal their dismissal through only one forum (instead of the current four); lowering the burden of proof necessary to fire federal workers; and expediting the dismissal process for hindering, threatening, abusive, or negligent employees.

The Pay Scale. Congress should reduce the pay gap between public and private employees by condensing the within-grade pay variance from 30 percent to 20 percent. Some of the savings from reduced step increases should go towards larger budgets for performance bonuses to help encourage and reward high-performers. To address the problem of managers giving virtually all employees pay increases, Congress should only require managers to develop performance improvement plans for workers it wants to fire (instead of all those for whom it does not approve a pay increase) and it should limit the appeals process for employees who do not receive pay increases.

Shifting from Defined Benefit to Defined Contribution Retirement Benefits. With the federal government providing as much as

Story," Office of Personnel Management, January 1999, https://archive.opm.gov/studies/perform.pdf (accessed May 9, 2017).

[23]Ibid.

[24]Bureau of Labor Statistics, Economic News Release, "Table 5. Layoffs and Discharges Levels and Rates by Industry and Region, Seasonally Adjusted," https://www.bls.gov/news.release/jolts.t05.htm (accessed May 9, 2017).

[25]James Sherk, "IRS Abuses: Ensuring that Targeting Never Happens Again," testimony before the Oversight and Government Reform Committee, U.S. House of Representatives, August 6, 2014.

[26]Heritage Foundation calculations using data from the OPM's "FedScope." The rate divides FY 2015 terminations for discipline/performance for employees with three or more years of service by December 2015 total federal employment for that same group of employees. U.S. Office of Personnel Management, "FedScope–Federal Human Resources Data," http://www.fedscope.opm.gov/ (accessed June 22, 2016).

three to four times the level of retirement benefits as the private sector, Congress should reduce the overall amount of retirement compensation for federal employees. Additionally, the government should shift towards defined contribution benefits that prevent future taxpayers from having to pay for the compensation of past government employees.[27] Any changes made to retirement benefits should not apply retroactively, however, as federal employees should receive the retirement benefits they have already earned.

A better retirement benefit system for taxpayers and employees would include: shifting all new and non-vested federal employees (those with fewer than five years of service) into an exclusively defined contribution retirement plan; maintaining already accrued benefits for workers with 5 to 24 years of service and allowing them to choose from three options for future benefit accruals; and maintaining the existing system for current retirees and for workers with 25 or more years of federal service.

For new and recent hires, the federal government's current 1 percent automatic contribution to workers' Thrift Savings Plans (TSP) would increase to 4 percent and the full match would rise from 5 percent to 8 percent. Workers with 5 to 24 years of experience could choose one of three options: (1) continue to accrue both FERS and TSP benefits with a higher employee contribution to FERS and other changes to future accruals; (2) maintain a frozen FERS benefit alongside higher government contributions to the TSP (4 percent automatic and up to an 8 percent match); or (3) shift entirely to the TSP by rolling over accrued FERS benefits into the TSP and receive higher TSP contributions. Nothing would change for current retirees or for workers with 25 years or more of federal service.

In addition to forcing the federal government to incur compensation costs immediately instead of shifting them to future taxpayers, defined contribution retirement plans provide workers with actual dollar contributions that they own and control. This allows workers to know their value at every point and time and can help individuals to make more informed decisions about their careers and retirement savings. Also, unlike defined benefit plans that are tenure-based and can be lost or minimized if workers change jobs, workers can carry defined contribution plans from one employer to another without sacrificing any value.

Paid Leave. The federal government provides significantly more total paid leave than the private sector. Federal workers with five years of service receive 20 paid vacation days, 13 paid sick days, and 10 paid holidays, for a total of 43 days per year.[28] Workers in the private sector who have paid leave typically receive 13 paid vacation days, 8 paid sick days and 8 paid holidays, for a total of 29 days per year.[29] The federal government should reduce its paid leave package by about eight

[27] Although agencies make contributions on behalf of their employees to the Federal Employees Retirement system, those contributions are similar to Social Security payroll taxes in that they amount to credits in the FERS fund, but the contributions are actually used to fund other government spending. These inter-government transfers allow the government to increase its gross debt without having to issue any new publicly held debt.

[28]The specified paid leave allowances are provided for employees with between 3 and 15 years of tenure. We use the example of an employee with five years of service because it allows a comparison to data on private-sector employees.

[29]Bureau of Labor Statistics, National Compensation Survey. Figures are mean vacation and sick leave days provided to private-sector workers in 2015 in companies with 100 or more employees, for employees who do not have consolidated vacation and sick leave plans.

days from the current 20/13/10 schedule to 15/10/10. Alternatively, or as an option, it could shift to a Paid Time Off (PTO) allowance of between 16 and 27 days per year, depending on tenure.

Workers' Health Insurance Benefits. The current, predominantly percentage-based subsidy for federal employees' health benefits discourages employees from choosing lower-cost health care plans because employees do not realizing most of the savings from choosing lower-cost plans. Congress should eliminate the requirement that employees pay at least 25 percent of their premium costs and instead provide a flat subsidy amount to workers regardless of the plan they choose.

Retirees' Health Insurance Benefits. In addition to generous health insurance subsidies during employment, the federal government extends those subsidies to certain retirees. A 2002 study by the CBO estimated the accrual cost of retiree health coverage to equal 6.4 percent of workers' pay.[30] Only 15 percent of private employers provide retiree health benefits. The government inequitably provides the retiree health insurance subsidy only to employees who retire directly from the federal government after five or more consecutive years of service leading up to retirement.[31] This can prevent older workers from moving out of federal employment and induce federal workers to begin collecting retirement benefits before they might otherwise desire to claim them. Moreover, with a minimum retirement age of only 57, workers can claim these taxpayer-financed benefits while working at jobs that otherwise would provide their health insurance (resulting in windfall benefits for employers who do not have to pay employees' insurance costs).

The federal government should eliminate the subsidy for retiree health benefits for new hires. Although this would not generate immediate budgetary savings, it would produce significant future savings.

Summary

The federal government provides a significant compensation premium to federal workers. The actual size of that premium is likely much higher than estimated by the CBO and other studies because the government provides significant compensation—thousands, and even tens of thousands of dollars in some cases—that is not included in any of the formal analyses. The federal government's compensation premium not only imposes unnecessary costs on taxpayers; its upside-down structure and lack of incentives or consequences hinders output and efficiency. The private sector offers an efficient model for maximizing productivity and minimizing costs. By shifting its compensation structure towards that of the private sector, the federal government could better protect taxpayer resources, attract and retain a high-value and more productive federal workforce, and make the federal government function better for all Americans.

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[30]Authors' calculations establish the 6.34 percent of pay cost by comparing the average salary of $54,656 in 2002 to the estimated $3,475 accrual cost of FEHB benefits as reported in Congressional Budget Office, "The President's Proposal to Accrue Retirement Costs For Federal Employees," June 2002, https://www.cbo.gov/sites/default/files/107th-congress-2001-2002/reports/accrual.pdf (accessed May 16, 2016).

[31]Office of Personnel Management, "Continuing FEHB Coverage into Retirement."

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